

REDSTONE

FEDERAL CREDIT UNION

May 23, 2014

Mr. Gerard Poliquin
Secretary to the NCUA Board
1775 Duke Street
Alexandria, VA 22314

Re: Risk Based Capital Proposed Rule

Dear Mr. Poliquin:

On behalf of the Board and management of Redstone Federal Credit Union, I would like to provide the following comment letter and submit it for the official record regarding the National Credit Union Administration (NCUA) Board's proposed risk based capital rule approved in January 2014. We appreciate the opportunity to provide our viewpoint on this crucially important proposed regulation that will have a tremendous impact on the value of the credit union charter over the years and decades to come and to express some of our concerns about the proposed rule. While we support the concept of risk based capital and would like to see a well-balanced plan put in place for credit unions, we are convinced that there is a potentially quite negative impact on credit unions if the rule finalized in its current proposed form.

One of the concerns we have (among others that we will reference in this comment letter) with the proposed risk based capital system is that it imposes onto an already well-defined statutory net worth requirement of 7% to be considered well capitalized under the Prompt Corrective Action (PCA) rules an additional regulatory capital requirement calculated to require reserves to also be 10.5% of risk-weighted assets. Yet, while proposing to add this additional regulatory capital requirement to the already established statutory net worth requirement, NCUA does not establish which of the two requirements should be considered the dominant one.

This is a crucially important question as the statistics NCUA itself has cited regarding this proposed rule indicate that it is very possible that a credit union could be in full compliance with one and not with the other. Having managed to the 7% net worth requirement to be considered well capitalized since its passage by Congress in 1998, it is not surprising that there will be a number of credit unions well capitalized under the PCA net worth requirements but – not having enough time to adjust the balance sheet before the very expedited effective date of this proposed rule – below well capitalized under this proposed rule if finalized in its current form

Whatever the structure of the final risk based capital rule, the threshold to be considered well capitalized and the risk weights assigned to each class of assets, we believe it is crucial that an effective date be thirty-six months after approval by the NCUA Board and its publishing in the Federal Register. Any less of time-frame for implementation presents a real risk of “knee jerk” decisions regarding a credit union's balance sheet management that could have long term negative ramifications for the credit union. A thirty-six month effective date will, in our view, provide credit unions with a more reasonable time to prepare for and manage to the final requirements of this risk based capital rule, whatever they may be.

Still the question remains: Would the primary regulatory expectation for credit union net worth and capital be the clearly established statutory requirement established by Congress in 1998 or the risk-based requirement being proposed now by NCUA in 2014? Which will generate

corrective action and what corrective action will be required if one standard is met but the other is not?

We recommend that NCUA, in the final rule, clarify this question. Our suggested clarification would be that, while both thresholds will be expected to be met, a credit union with more than the statutory 7% net worth of total assets level but less than the final threshold to be well capitalized under the risk based capital rule (which we strongly feel should be 9% since an additional two percent capital cushion over what seems to be the equivalent of a 7% net worth leverage ratio under the statutory PCA model is certainly sufficient and more comparable to the banking industry Basel standards than the 350 basis points proposed in this rule) would be required to provide a risk based capital restoration plan to demonstrate how the credit union will bring its risk based capital over the required level within another thirty-six months. Any additional corrective action should not be required, unless the supervisory process discovers related issues of a safety and soundness priority.

We would also recommend that, if a credit union exceeds both the 7% statutory net worth requirement under PCA and the final threshold for the risk based capital rule (which we believe should be 9%), the credit union should be recognized as being effective at risk management under both requirements and provided with some consideration from a supervisory perspective.

In other words, this proposal should not be – as it seems to be – all stick and no carrot. We believe that a credit union exceeding both the net worth and risk based capital thresholds should have expedited waiver approvals, blanket waivers on fixed assets and eighteen month examination cycles if its CAMEL rating is one or two.

In addition, we have strong objection to the provision of the proposed rule allowing examiners to add additional capital requirements on a subjective basis to the risk based threshold perhaps as often as annually. It is impossible to manage to a standard that is not fixed. Examiners already have examination findings, DORs and LUAs at their disposal to get the attention of a credit union in need of supervisory attention. The ability of an examiner to arbitrarily raise the risk based capital threshold is not good public policy, nor is it good agency policy. NCUA will likely find itself facing many more appeals, inquiries and ombudsman complaints if this troublesome provision is retained in the final rule. We strongly suggest that it be removed from the final rule.

Another concern we have is that, with the growing number of credit union mergers and even purchase/acquisition of assets from other financial institutions, goodwill value is becoming more of a balance sheet issue under Generally Accepted Accounting Principles (GAAP). We believe that this proposal effectively devalues goodwill completely. While we recognize that there must be a reasonable dollar value to a non-cash asset such as goodwill and that the capital standards must focus on actual dollars on reserve to protect the share insurance fund, we encourage the agency to seriously consider the GAAP standards related to goodwill and to try to bring some comparability into place for this important area of balance sheet asset today – an area only certain to grow in the years to come.

We also have serious concerns about what appear to be the arbitrary assignment of risk weights to several categories of credit union assets. In these cases it seems to be that NCUA is merely supplementing the one-size-fits-all PCA net worth standards with about a dozen one-size-fits-all asset categories. If the agency is going to move into a more sophisticated capital regime in 2014 and beyond, its risk weighting system needs to more accurately reflect the sophisticated balance sheets of this era of credit union risk management.

For example, let's take a look at business lending. No matter how effectively a credit union has managed the risk in a business lending portfolio and of how small the historical losses may be in that portfolio, the risk weighted calculations of all non-delinquent performing business loans ranges from \$1.00 to \$2.00 per dollar of loan value – depending upon the concentration of business loans. No recognition of loan to value, credit history or even the credit union's historical charge-off and delinquency rates in this portfolio is built into the system.

Largely the same approach takes place with mortgage loans. A 70% loan-to-value mortgage is weighted the same risk as a 100% loan-to-value mortgage. A borrower with a 540 credit score is likewise weighted at the same risk as one with a 750 credit score. A credit union with less than 1% average annual charge off ratio over the toughest five year period of mortgage portfolio management in the nation's history (2008-2013) sees its mortgage portfolio weighted the same as a credit union with 5% annual average charge off ratio over the same period. We are hard pressed to see how such a one-size-fits-all approach effectively and accurately measures risk in an individual credit union.

Neither set of risk weights take into consideration other derivative assets purchased to offset the risk as an insurance policy against interest rate fluctuations. Again, if the capital structure is to be sophisticated enough to require higher capital reserves for higher risk credit unions, then it must be sophisticated enough to truly capture both the actual risk and the balance sheet strategies in place to manage and insure against that risk. In its current structure, this proposal falls well short in this regard.

Another important consideration and compelling reason for NCUA to postpone the implementation date on a revision to risk based capital is the FASB's proposal on Credit Impairment Standard. FASB issued – Financial Instruments – Credit Losses (Subtopic 825-15) on December 20, 2012 and have been in deliberations with IASB to approve several key concepts within the credit impairment standard. The FASB is currently reviewing and evaluating the comment letters from its proposed standard. There is no definite implementation date for the credit impairment model, however, FASB commonly gives a reasonable notice, therefore it would be 2017 at the earliest. The key question is why should credit unions double the capital reserve for loans? The allowance for loan loss takes care of the capital reserve for losses on loans and the accounting standards mandate this. For this reason, credit loss on loans should not be included in the risk based capital calculation.

Such an approach that does not reward effective risk management and a balance sheet structure designed to insure against the risk contained within it seems to make little sense for either NCUA or the credit unions they regulate and insure.

Mr. Gerard Poliquin
May 23, 2014
Page four

While there could be other solutions as well to this need for additional sophistication in monitoring a credit union's risk management, in keeping with the desire of the agency to drive the risk based capital standards through data available through the 5300 Call Reports we would recommend that there should be added to the formula an earned credit to the weighted risk in the business loan and mortgage categories based upon a three to five year historical performance of the portfolio. A deduction of up to 50 basis points in each category based upon average annual losses for the most recent three to five year period being less than two percent would provide some compensating recognition of the fact that every credit union does not manage lending as well as others.

This same type of earned risk management credit could also be provided in the consumer lending portfolio which does not reflect any risk weight differential between an unsecured credit card and an auto loan with a lien on a vehicle worth perhaps 90-100 percent of the loan amount. In short, there needs to be a recognition of the different risk factors within each individual lending category – not just a category by category approach to one-size-fits-all.

Again, we appreciate the opportunity to comment on this important and far reaching proposal. We respectfully encourage you to consider our recommended improvements to the regulation which we feel, if adopted, would make it a much better approach to a much-needed risk based capital system for credit unions.

Please do not hesitate to contact me if I or the team at Redstone Federal Credit Union can be a source of further information or assistance to you on this matter.

Sincerely,



Joseph H. Newberry
President/CEO
Redstone Federal Credit Union

C: Congressman Mo Brooks
Senator Richard Shelby
Senator Jeff Sessions
The Honorable Debbie Matz
The Honorable Michael E. Fryzel
The Honorable Rick Metsger
Board Member Designate J. Mark McWatters